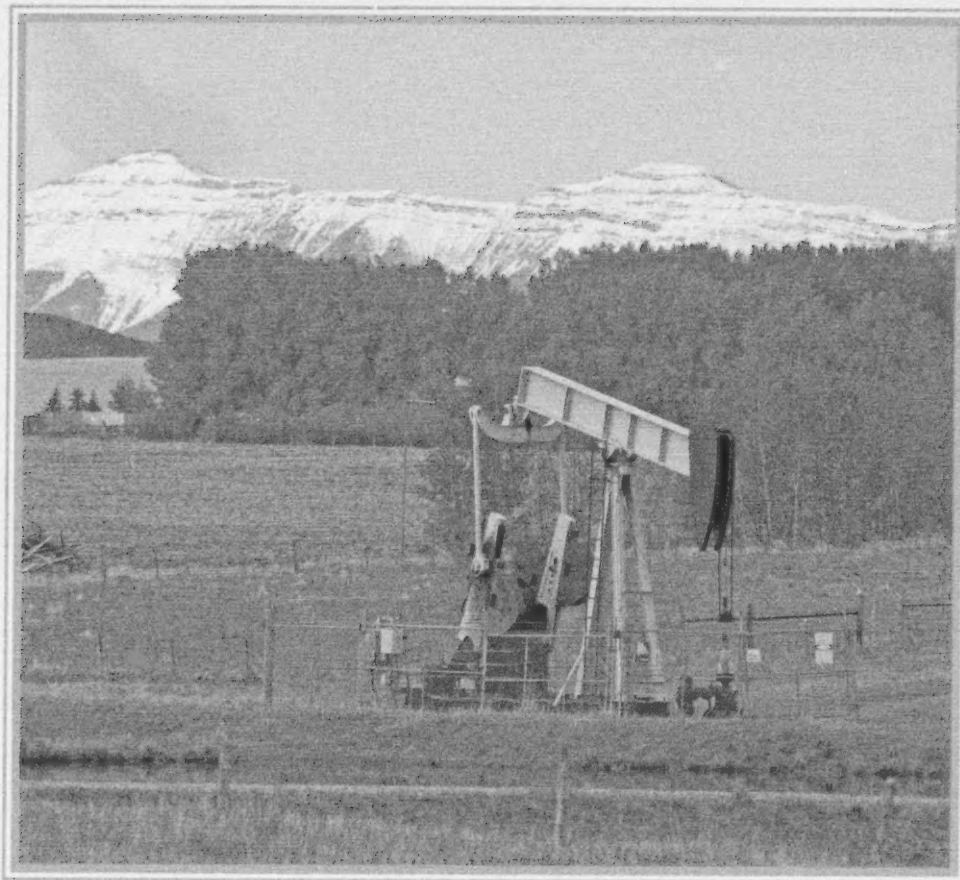


# Alberta Heritage Savings Trust Fund

FIRST QUARTER 2014–2015



Alberta





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# Highlights

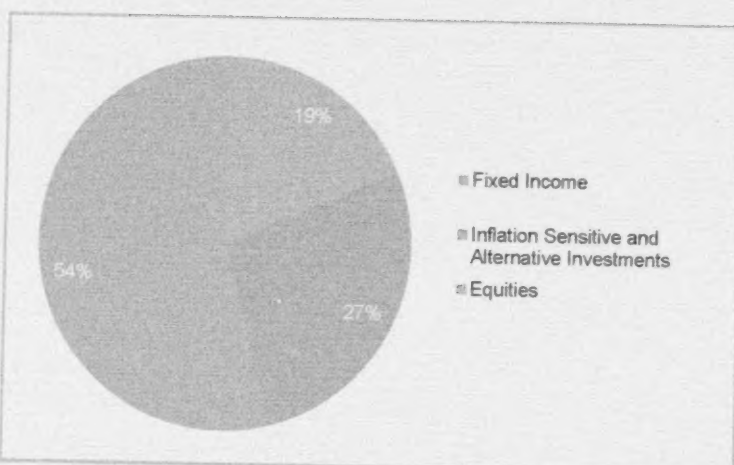
**2.10%**  
(net of fees)

RATE OF RETURN

**\$17.5**  
billion

FAIR VALUE OF NET ASSETS

Asset Mix as at June 30, 2014



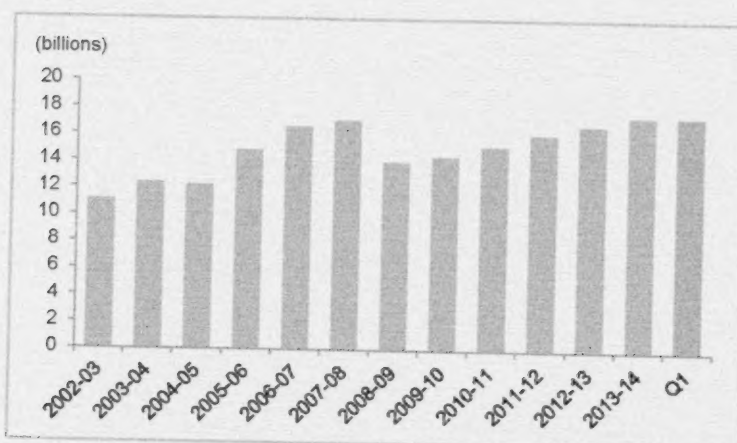
**\$478**  
million

GROSS INCOME

**\$38**  
million

INVESTMENT EXPENSES

Market Value



**\$90**  
million

INVESTMENT INCOME  
TO BE RETAINED FOR  
INFLATION-PROOFING

**\$350**  
million

PAYABLE TO THE GENERAL  
REVENUE FUND



## THE 2014-15 FIRST QUARTER HIGHLIGHTS

The Alberta Heritage Savings Trust Fund, which is the Province's main savings vehicle, had a fair value at June 30, 2014 of \$17.5 billion and produced a 2.1 per cent rate of return for the first quarter of fiscal 2014-15. The Fund generated net investment income of \$440 million during the quarter ended June 30, 2014, of this, \$90 million of this income will be retained in the Fund for inflation proofing while the remaining \$350 million will be transferred to the province.

*Budget 2014* took significant steps towards defining and putting into practice a renewed vision and purpose for Alberta's savings. This includes the establishment of the Alberta Future Fund and the two innovation endowments within the Heritage Fund and a substantial increase to the size of the Alberta Heritage Scholarship Fund.

The Social Innovation Endowment Account was created to advance the goals and principles of Alberta's Social Policy Framework, strengthening and renewing Alberta's social sector. It will support new ideas, risk-sharing and creative collaboration with the not-for-profit sector, Alberta communities and private funding bodies. Recognizing the importance of culture to Albertans' social well-being, this endowment will also help support the long-term sustainability of cultural organizations by stimulating innovation and partnerships in the cultural sector. This endowment account was started with \$500 million in 2014-15 and will be increased by \$500 million in 2015-16.

Recognizing that Alberta's agricultural sector, including its related value-added industries, is a cornerstone of Alberta's economy, the government has established the Agriculture and Food Innovation Endowment Account with an amount of \$200 million. The main goals of the endowment will be to enhance basic and applied agricultural research in the province and to support product development and commercialization opportunities.

Regular annual disbursements will be made from the Heritage Fund, supporting the goals of the two endowment accounts. Ultimately annual disbursements will be a maximum of 4.5 per cent of the three year moving average market value of each of the endowments. As a transitional measure annual funding in respect of the Agriculture and Food Innovation Endowment Account will be a maximum of \$9 million per year for 3 years commencing in 2014-15 and funding in respect of the Social Innovation Endowment Account will commence in 2015-16 with maximum of \$22.5 million. The endowment accounts will get a rate of return adjustment equal to the return of the Heritage Fund to ensure their growth into the future.

The Alberta Heritage Scholarship Fund will be increased by \$200 million which will be dedicated to supporting trades focused education. This money will come from the Alberta Heritage Savings Trust Fund. During the first quarter of fiscal 2014-15, \$50 million of the \$200 million was transferred to the Alberta Heritage Scholarship Fund. The remainder will be transferred over the course of the current fiscal year.

The Alberta Future Fund will be allocated \$200 million annually for ten years beginning this fiscal year. The Fund will be given the same rate of return adjustment as the other endowments, to ensure its future growth. Under the terms of the Savings Management Act, the Alberta Future Fund will be available to fund investments that provide long-term benefits to Albertans and the Alberta economy, if authorized by a vote of the Legislature.

## ECONOMIC UPDATE

US real GDP expanded at an annual rate of 4.0% in the first quarter of fiscal 2014-15 after contracting by 2.1 per cent in the final quarter of last the fiscal year. Some rebound was expected after severe winter weather weighed on the US economy in the final quarter. The first quarter numbers are consistent with US employment figures, which have been rising consistently by over 200,000 jobs a month since February. Indicators of consumer and business confidence have also been steadily increasing since January, which suggests that after years of false starts, the US economy is poised for a period of sustained growth.

Like the US, Canada will look to rebound in the second quarter after disappointing growth of just 1.0 per cent in the first quarter. Early indications are that this is likely, led by real goods exports, which spiked in the first quarter of this fiscal year. Unlike the US, however, Canadian labour markets continue to struggle. Outside Alberta, there has been little employment growth over the last two years and the unemployment rate has stopped falling.

After crawling out of recession last year, the Euro zone continues to show only modest and uneven growth. Though activity in China picked up after a weak final quarter of the last fiscal year, the growth in China is expected to be lower in 2014 than in 2013. This is due in part to measures taken by authorities to restrain credit growth. Activity in Russia has declined as a result of the crisis in Ukraine, which has investors nervous about trade sanctions.

## INVESTMENT PERFORMANCE

The Heritage Fund is invested by Alberta Investment Management Corporation (AIMCo) in a globally diversified portfolio across numerous asset classes. For the quarter ending June 30, 2014, the Heritage Fund earned a 2.1 per cent return on a fair value basis. The Fund's equity holdings returned 2.5 per cent during the quarter, led by a 6.4 per cent return on Canadian equities. The fixed income portfolio returned 2.3 per cent, while the inflation-sensitive and alternatives portfolio returned 1.4 per cent for the quarter.

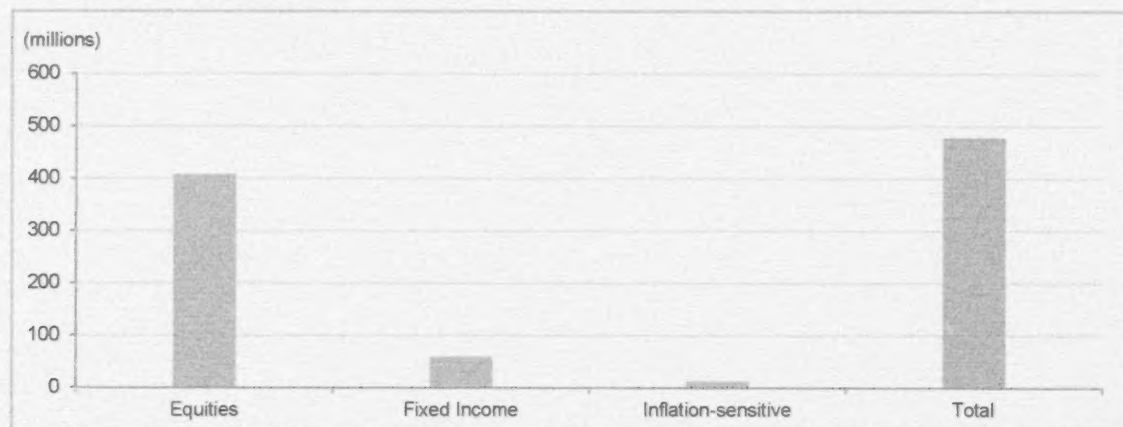
Asset Class Return versus Benchmark

	Q1 Return	Q1 Benchmark
Total Fund	2.1	2.5
Fixed Income	2.3	2.0
Inflation Sensitive and Alternative Investments	1.4	3.4
Real Estate	2.2	1.6
Infrastructure/Private Debt	(0.2)	7.5
Timberland	(0.5)	7.5
Equities	2.5	2.2
Canadian	6.4	6.4
Global	1.7	1.4
Private	2.4	1.4

## INVESTMENT INCOME

The Fund earned \$478 million during the first quarter of the fiscal year. Net income was \$440 million after expenses of \$38 million. Of this, \$350 million of the net income earned this quarter will be transferred to the province at the end of the fiscal year and \$90 million will be retained in the Fund for inflation proofing. The equity portfolio earned gross income of \$407 million, while the fixed income portfolio earned \$59 million and the inflation-sensitive portfolio earned \$12 million this quarter.

Investment Income by Asset Class





## INVESTMENTS

The Heritage Fund has long-term asset allocation targets of 20 per cent fixed income, 30 per cent inflation sensitive and alternatives, and 50 per cent equities. The actual asset mix, on June 30, 2014 was inflation sensitive and alternatives at 27.3 per cent, equities at 54.1 per cent and fixed income at 18.6 per cent.

### Asset Mix

	June 2014	March 2014	Policy range
<b>FIXED INCOME AND MONEY MARKET (20%)</b>	<b>18.6%</b>	<b>18.8%</b>	<b>15-45%</b>
Deposits and short-term	0.2%	0.2%	0-25%
Bonds and mortgages	18.4%	18.6%	10-35%
Long bonds	0.0%	0.0%	0-10%
<b>INFLATION-SENSITIVE AND ALTERNATIVE INVESTMENTS (30%)</b>	<b>27.3%</b>	<b>26.9%</b>	<b>15-40%</b>
Real estate	18.9%	18.4%	10-20%
Real return bonds	0.0%	0.0%	0-10%
Infrastructure	6.2%	6.3%	5-15%
Timberland	2.2%	2.2%	0-5%
<b>EQUITIES (50%)</b>	<b>54.1%</b>	<b>54.3%</b>	<b>35-70%</b>
Public			
Canadian	8.3%	8.1%	5-15%
Global developed	33.9%	34.4%	20-65%
Emerging markets	4.9%	4.7%	0-10%
Frontier markets	0.0%	0.0%	0-5%
Private	7.0%	7.1%	0-10%



# **Alberta Heritage Savings Trust Fund**

INTERIM FINANCIAL STATEMENTS (UNAUDITED)

JUNE 30, 2014

# Statement of Financial Position

As at June 30, 2014  
(in millions)

	June 30, 2014	March 31, 2014
<b>Financial assets</b>		
Investments (Note 3)	\$ 17,829	\$ 17,656
Accrued income	16	11
	<u>\$ 17,845</u>	<u>\$ 17,667</u>
<b>Liabilities</b>		
Due to the General Revenue Fund	\$ 350	\$ 147
	<u>350</u>	<u>147</u>
<b>Net financial assets (Note 5)</b>		
Accumulated operating surplus	15,046	15,006
Accumulated remeasurement gains	2,449	2,514
	<u>17,495</u>	<u>17,520</u>
	<u>\$ 17,845</u>	<u>\$ 17,667</u>

*The accompanying notes are part of these financial statements.*

# Statement of Operations and Accumulated Surplus

Three Months Ended June 30, 2014  
(in millions)

	June 30, 2014	June 30, 2013
Investment income (Note 7)	\$ 478	\$ 416
Investment expenses (Note 8)	(38)	(29)
<b>Net income from operations</b>	<b>440</b>	<b>387</b>
Transfers to the General Revenue Fund (Note 5b)	(350)	(320)
<b>Net surplus retained in the Fund for inflation-proofing (Note 5b)</b>	<b>90</b>	<b>67</b>
Transfers to the Alberta Heritage Scholarship Fund (Note 5d)	(50)	-
<b>Accumulated operating surplus, beginning of period</b>	<b>15,006</b>	<b>14,813</b>
<b>Accumulated operating surplus, end of period</b>	<b>\$ 15,046</b>	<b>\$ 14,880</b>

# Statement of Remeasurement Gains and Losses

Three Months Ended June 30, 2014  
(in millions)

	June 30, 2014	June 30, 2013
Accumulated remeasurement gains, beginning of period	\$ 2,514	\$ 1,966
Unrealized loss on investments	(4)	(125)
Less: Amounts reclassified to the Statement of Operations - realized gains on investments	(61)	(76)
<b>Accumulated remeasurement gains, end of period</b>	<b>\$ 2,449</b>	<b>\$ 1,765</b>

*The accompanying notes are part of these financial statements.*



# Statement of Cash Flows

Three Months Ended June 30, 2014  
(in millions)

	June 30, 2014	June 30, 2013
<b>Operating transactions</b>		
Net income from operations	\$ 440	\$ 387
Non-cash items included in net income	(61)	(76)
	379	311
Increase in accounts receivable	(5)	(4)
Decrease in accounts payable	-	(5)
Cash provided by operating transactions	374	302
<b>Investing transactions</b>		
Proceeds from disposals, repayments and redemptions of investments	589	673
Purchase of investments	(775)	(586)
Cash (used in) provided by investing transactions	(186)	87
<b>Transfers</b>		
Transfers to the General Revenue Fund	(350)	(320)
Transfers to the Alberta Heritage Scholarship Fund	(50)	-
Increase (decrease) in amounts due to the General Revenue Fund	203	(65)
Cash used in transfers	(197)	(385)
<b>(Decrease) increase in cash</b>	<b>(9)</b>	<b>4</b>
<b>Cash at beginning of period</b>	<b>43</b>	<b>44</b>
<b>Cash at end of period</b>	<b>\$ 34</b>	<b>\$ 48</b>
<b>Consisting of Deposits in the Consolidated Cash Investment Trust Fund (CCITF) *</b>	<b>\$ 34</b>	<b>\$ 48</b>

\* The CCITF is a highly-liquid, short-term money market pooled fund consisting primarily (91%) of securities with maturities of less than one year.

*The accompanying notes are part of these financial statements.*

# Notes to the Financial Statements

June 30, 2014  
(in millions)

## NOTE 1 AUTHORITY AND MISSION

The Alberta Heritage Savings Trust Fund (the Fund) operates under the authority of the *Alberta Heritage Savings Trust Fund Act*, Chapter A-23, Revised Statutes of Alberta 2000 (the Act), as amended.

The preamble to the Act describes the mission of the Fund as follows:

*"To provide prudent stewardship of the savings from Alberta's non-renewable resources by providing the greatest financial returns on those savings for current and future generations of Albertans."*

## NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND REPORTING PRACTICES

The financial statements are prepared in accordance with Canadian public sector accounting standards.

The accounting policies of significance to the Fund are as follows:

### a) VALUATION OF INVESTMENTS

Investments are recorded at fair value. As disclosed in Note 3, the Fund's investments consist primarily of direct ownership in units of pooled investment funds ("the pools"). The pools are established by Ministerial Order 9/89, being the Pooled Fund Establishment and Maintenance Order, pursuant to the *Financial Administration Act* of Alberta, Chapter F-12, Section 45, and the *Alberta Investment Management Corporation Act* of Alberta, Chapter A-26.5, Section 15 and 20. Participants in pools include government and non-government funds and plans.

Contracts to buy and sell financial instruments in the pools are between the Province of Alberta and the third party to the contracts. Participants in the pools are not party to the contracts and have no control over the management of the pool and the selection of securities in the pool. Alberta Investment Management Corporation (AIMCo) controls the creation of the pools and the management and administration of the pools including security selection. Accordingly, the Fund does not report the financial instruments of the pools on its statement of financial position.

The Fund becomes exposed to the financial risks and rewards associated with the underlying financial instruments in a pool when it purchases units issued by the pools and loses its exposure to those financial risks and rewards when it sells its units. The Fund reports its share of the financial risks in Note 4.

The fair value of units held by the Fund is derived from the fair value of the underlying financial instruments held by the pools as determined by AIMCo (see Note 3b). Investments in units are recorded in the Fund's accounts. The underlying financial instruments are recorded in the accounts of the pools. The pools have a market-based unit value that is used to distribute income to the pool participants and to value purchases and sales of the pool units. The pools include various financial instruments such as bonds, equities, real estate, derivatives, investment receivables and payables and cash.

The Fund's cut-off policy for valuation of investments, investment income and investment performance is based on valuations confirmed by AIMCo on the fourth business day following the period end. Differences in valuation estimates provided to Treasury Board and Finance after the period end cut-off date are reviewed by management. Differences considered immaterial by management are included in investment income in the following period.

Investments in units of the pools are managed and evaluated on a fair value basis. As such, all investments are designated and recorded in the financial statements at fair value.

Investments in units are recorded in the Fund's accounts on a trade date basis.

All purchases and sales of the pool units are in Canadian dollars.

Fair value is the amount of consideration agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

**b) INVESTMENT INCOME**

- i) Income distributions from the pools are recorded in the Fund's accounts and included in investment income on the statement of operations and accumulated surplus (see Note 7). Income distributions are based on the Fund's pro-rata share of total units issued by the pools.
- ii) Realized gains and losses on disposal of units are recorded in the Fund's accounts and included in income on the statement of operations and accumulated surplus. Realized gains and losses on disposal of units are determined on an average cost basis.
- iii) Investment income is recorded on an accrual basis. Investment income is accrued when there is reasonable assurance as to its measurement and collectability.

**c) INVESTMENT EXPENSES**

- i) Investment expenses include all amounts, including transaction costs, incurred by the Fund to earn investment income (see Note 8). Investment expenses are recorded on an accrual basis.
- ii) Other expenses related to the direct administration of the Fund are charged to the Fund on an accrual basis.

**d) REMEASUREMENT GAINS AND LOSSES**

Accumulated remeasurement gains primarily represent the excess of the fair value of the pool units at period end over the cost of the pool units. Changes in accumulated remeasurement gains and losses are recognized in the statement of remeasurement gains and losses. Changes in accumulated remeasurement gains and losses during the period include unrealized increases and decreases in fair value of the pooled units and realized gains and losses on sale of the pool units. When the pool units are sold (derecognized), any accumulated unrealized gain or loss associated with the investment becomes realized and is included in net income on the statement of operations and accumulated surplus.

e) MEASUREMENT UNCERTAINTY

Measurement uncertainty exists in the fair values reported for certain investments such as private equities, infrastructure, private debt and loans, private real estate, hedge funds, timberland investments, and other investments where no readily available market exists. The fair values of these investments are based on estimates. Estimated fair values may not reflect amounts that could be recognized upon immediate sale, or amounts that ultimately may be recognized. Accordingly, the estimated fair values may differ significantly from the value that would have been used had a ready market existed for these investments.

**NOTE 3** INVESTMENTS (in millions)

The carrying amounts of the Fund's investments are recorded on a fair value basis. The Fund's investments are managed at the asset class level for purposes of evaluating the Fund's risk exposure and investment performance against approved benchmarks based on fair value. AIMCo invests the Fund's assets in accordance with the Statement of Investment Policies and Goals (SIP&G) approved by the of President of Treasury Board and Minister of Finance. The fair value of the pool units is based on the Fund's share of the net asset value of the pooled fund. The pools have a market based unit value that is used to allocate income to participants of the pool and to value purchases and sales of the pool units. AIMCo is delegated authority to independently purchase and sell securities in the pools and Fund, and units of the pools, within the ranges approved for each asset class (see Note 4).

Asset class	Fair Value Hierarchy <sup>(a)</sup>			June 30,	March 31,
	Level 1	Level 2	Level 3	2014	2014
<b>Interest-bearing securities</b>					
Deposits in CCITF	\$ -	\$ 34	\$ -	\$ 34	\$ 43
Bonds, mortgages and private debt	-	2,132	1,145	3,277	3,269
	-	2,166	1,145	3,311	3,312
<b>Equities</b>					
Canadian	1,003	485	-	1,488	1,435
Global developed	3,402	823	1,818	6,043	6,063
Emerging markets	655	89	124	868	833
Private	-	-	1,246	1,246	1,260
	5,060	1,397	3,188	9,645	9,591
<b>Inflation sensitive</b>					
Real estate	-	-	3,373	3,373	3,257
Infrastructure	-	-	1,110	1,110	1,109
Timberland	-	-	390	390	387
	-	-	4,873	4,873	4,753
<b>Total Fair Value of Investments</b>	<b>\$ 5,060</b>	<b>\$ 3,563</b>	<b>\$ 9,206</b>	<b>\$ 17,829</b>	<b>\$ 17,656</b>



a) **Fair Value Hierarchy:** The quality and reliability of information used to estimate the fair value of investments is classified according to the following fair value hierarchy with level 1 being the highest quality and reliability.

- **Level 1** - fair value is based on quoted prices in an active market. This level includes publicly traded listed equity investments totalling \$5,060 (March 31, 2014: \$4,897).
- **Level 2** - fair value is estimated using valuation techniques that make use of market-observable inputs other than quoted market prices. This level includes debt securities and derivative contracts not traded on a public exchange totalling \$3,563 (March 31, 2014: \$3,703). For these investments, fair value is either derived from a number of prices that are provided by independent pricing sources or from pricing models that use observable market data such as swap curves and credit spreads.
- **Level 3** - fair value is estimated using inputs based on non-observable market data. This level includes private mortgages, hedge funds, private equities and all inflation sensitive investments totalling \$9,206 (March 31, 2014: \$9,056).

**Reconciliation of Level 3 Investments**

	June 30, 2014	March 31, 2014
Balance, beginning of year	\$ 9,056	\$ 8,098
Unrealized gains	(18)	637
Purchases of Level 3 pooled fund units	411	1,363
Sale of Level 3 pooled fund units	(243)	(1,042)
<b>Balance, end of year</b>	<b>\$ 9,206</b>	<b>\$ 9,056</b>

b) **Valuation of Financial Instruments recorded by AIMCo in the Pools**

The methods used by AIMCo to determine the fair value of investments recorded in the pools is explained in the following paragraphs:

- **Interest-bearing securities:** Public interest-bearing securities are valued at the period end closing sale price or the average of the latest bid and ask prices quoted by an independent securities valuation company. Private mortgages are valued based on the net present value of future cash flows discounted using appropriate interest rate premiums over similar Government of Canada benchmark bonds trading in the market. Private debt and loans is valued similar to private mortgages. The fair value of directly held loans is estimated by management based on the present value of discounted cash flows.
- **Equities:** Public equities are valued at the period end closing sale price or the average of the latest bid and ask prices quoted by an independent securities valuation company. The fair value of hedge fund investments is estimated by external managers. The fair value of private equities is estimated by managers or general partners of private equity funds, pools and limited partnerships. Valuation methods for private equities may encompass a broad range of approaches. The cost approach is used to value companies without either profits or cash flows. Established private companies are valued using the fair market value approach reflecting conventional valuation methods including discounted cash flows and earnings multiple analysis.



- **Inflation sensitive investments:** The estimated fair value of private real estate investments is reported at the most recent appraised value, net of any liabilities against the real property. Real estate properties are appraised annually by qualified external real estate appraisers. Appraisers use a combination of methods to determine fair value including replacement cost, direct comparison, direct capitalization of earnings and discounted cash flows. The fair value of timberland investments is appraised annually by independent third party evaluators. Infrastructure investments are valued similar to private equity investments.
- **Foreign currency:** Foreign currency transactions in pools are translated into Canadian dollars using average rates of exchange. At period end, the fair value of investments in other assets and liabilities denominated in a foreign currency are translated at the period end exchange rates.
- **Derivative contracts:** The carrying value of derivative contracts in a favourable and unfavourable position is recorded at fair value and is included in the fair value of the pools (see Note 4f). The estimated fair value of equity and bond index swaps is based on changes in the appropriate market-based index net of accrued floating rate interest. Interest rate swaps and cross-currency interest rate swaps are valued based on discounted cash flows using current market yields and exchange rates. Credit default swaps are valued based on discounted cash flows using current market yields and calculated default probabilities. Forward foreign exchange contracts and futures contracts are valued based on quoted market prices. Options to enter into interest rate swap contracts are valued based on discounted cash flows using current market yields and volatility parameters which measure changes in the underlying swap. Warrants and rights are valued at the period end closing sale price or the average of the latest bid and ask prices quoted by an independent securities valuation company.

#### NOTE 4 INVESTMENT RISK MANAGEMENT (in millions)

The Fund is exposed to financial risks associated with the underlying securities held in the pools created and managed by AIMCo. These financial risks include credit risk, market risk and liquidity risk. Credit risk relates to the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract. Market risk is comprised of currency risk, interest rate risk and price risk. Liquidity risk is the risk the Fund will not be able to meet its obligations as they fall due.

The investment policies and procedures of the Fund are clearly outlined in the SIP&G approved by the Ministry of Treasury Board and Finance. The purpose of the SIP&G is to ensure the Fund is invested and managed in a prudent manner in accordance with current, accepted governance practices incorporating an appropriate level of risk. The Ministry of Treasury Board and Finance manages the Fund's return-risk trade-off through asset class diversification, target ranges on each asset class, diversification within each asset class, quality constraints on fixed income instruments and restrictions on amounts exposed to countries designated as emerging markets. Forward foreign exchange contracts may be used to manage currency exposure in connection with securities purchased in a foreign currency (see Note 4b).

In order to earn the best possible return at an acceptable level of risk, the Minister has approved the following target policy asset mix:

Asset Class	Target Asset Policy	Actual Asset Mix			
		June 30, 2014		March 31, 2014	
Interest-bearing securities	15 - 45%	\$ 3,311	18.6%	\$ 3,312	18.8%
Equities	35 - 70%	9,645	54.1%	9,591	54.3%
Inflation sensitive	15 - 40%	4,873	27.3%	4,753	26.9%
		\$ 17,829	100.0%	\$ 17,656	100.0%

#### a) Credit Risk

##### i) Debt securities

The Fund is indirectly exposed to credit risk associated with the underlying debt securities held in the pools managed by AIMCo. Counterparty credit risk is the risk of loss arising from the failure of a counterparty to fully honour its financial obligations. The credit quality of financial assets is generally assessed by reference to external credit ratings. Credit risk can also lead to losses when issuers and debtors are downgraded by credit rating agencies usually leading to a fall in the fair value of the counterparty's obligations. Credit risk exposure for financial instruments is measured by the positive fair value of the contractual obligations with counterparties. The fair value of all investments reported in Note 3 is directly or indirectly impacted by credit risk to some degree. The majority of investments in debt securities are with counterparties with credit ratings considered to be investment grade.

The table below summarizes debt securities by counterparty credit rating at June 30, 2014:

Credit rating	June 30, 2014	March 31, 2014
Investment Grade (AAA to BBB-)	69.6%	70.3%
Speculative Grade (BB+ or lower)	0.6%	0.3%
Unrated	29.8%	29.4%
	100.0%	100.0%

##### ii) Counterparty default risk - derivative contracts

The Fund is exposed to counterparty credit risk associated with the derivative contracts held in the pools. The maximum credit risk in respect of derivative financial instruments is the fair value of all contracts with counterparties in a favourable position (see Note 4f). The pools can only transact with counterparties to derivative contracts with a credit rating of A+ or higher by at least two recognized ratings agencies. Provisions are in place to either transfer or terminate existing contracts when the counterparty has their credit rating downgraded. The exposure to credit risk on derivatives is reduced by entering into master netting agreements and collateral agreements with counterparties. To the extent that any unfavourable contracts with the counterparty are not settled, they reduce the net exposure in respect of favourable contracts with the same counterparty.

### iii) Security lending risk

To generate additional income, the pools participate in a securities-lending program. Under this program, the custodian may lend investments held in the pools to eligible third parties for short periods. At June 30, 2014, the Fund's share of securities loaned under this program is \$398 million (March 31, 2014: \$320 million) and collateral held totals \$418 million (March 31, 2014: \$336 million). Securities borrowers are required to provide the collateral to assure the performance of redelivery obligations. Collateral may take the form of cash, other investments or a bank-issued letter of credit. All collateralization, by the borrower, must be in excess of 100% of investments loaned.

### b) Foreign currency risk

The Fund is exposed to foreign currency risk associated with the underlying securities held in the pools that are denominated in currencies other than the Canadian dollar. Foreign currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The fair value of investments denominated in foreign currencies is translated into Canadian dollars using the reporting date exchange rate. As a result, fluctuations in the relative value of the Canadian dollar against these foreign currencies can result in a positive or negative effect on the fair value of investments. Approximately 44% of the Fund's investments, or \$7,906 million, are denominated in currencies other than the Canadian dollar, with the largest foreign currency exposure being to the US dollar (23%) and the euro (5%).

If the value of the Canadian dollar increased by 10% against all other currencies, and all other variables are held constant, the potential loss in fair value to the Fund would be approximately 4.4% of total investments (March 31, 2014: 4.4%).

The following table summarizes the Fund's exposure to foreign currency investments held in the pools at June 30, 2014:

Currency	June 30, 2014		March 31, 2014	
	Fair Value	Sensitivity	Fair Value	Sensitivity
U.S. dollar	\$ 4,123	\$ (412)	\$ 4,171	\$ (417)
Euro	941	(94)	886	(89)
British pound sterling	586	(59)	600	(60)
Japanese yen	506	(51)	461	(46)
Australian dollar	242	(24)	193	(19)
Swiss franc	233	(23)	234	(23)
Other foreign currency	1,275	(128)	1,245	(125)
<b>Total foreign currency investments</b>	<b>\$ 7,906</b>	<b>\$ (791)</b>	<b>\$ 7,790</b>	<b>\$ (779)</b>

### c) Interest rate risk

The Fund is exposed to interest rate risk associated with the underlying interest-bearing securities held in the pools managed by AIMCo. Interest rate risk relates to the possibility that the fair value of investments will change due to future fluctuations in market interest rates. In general, investment returns from bonds and mortgages are sensitive to changes in the level of interest rates, with longer term interest bearing securities being more sensitive to interest rate changes than shorter-term bonds. If interest rates increased by 1%, and all other variables are held constant, the potential loss in fair value to the Fund would be approximately 0.8% of total investments (March 31, 2014: 0.8%).

**d) Price risk**

Price risk relates to the possibility that units will change in fair value due to future fluctuations in market prices of equities held in the pools caused by factors specific to an individual equity investment or other factors affecting all equities traded in the market. The Fund is exposed to price risk associated with the underlying equity investments held in the pools managed by AIMCo. If equity market indices (S&P/TSX, S&P500, S&P1500 and MSCI ACWI and their sectors) declined by 10%, and all other variables are held constant, the potential loss in fair value to the Fund would be approximately 5.7% of total investments (March 31, 2014: 5.8%). Changes in fair value of investments are recognized in the statement of remeasurement gains and losses.

**e) Liquidity risk**

Liquidity risk is the risk that the Fund will encounter difficulty in meeting obligations associated with its financial liabilities. Liquidity requirements of the Fund are met through income generated from investments, and by investing in units of pools that hold publicly traded liquid assets traded in an active market that are easily sold and converted to cash. Units in pools that hold private investments like real estate, timberland, infrastructure and private equities are less easily converted to cash since the underlying securities are illiquid because they take more time to sell. The Fund's main liabilities include transfers payable to the General Revenue Fund and payables related to purchase of units.

**f) Use of Derivative Financial Instruments in Pooled Investment Funds**

The Fund has indirect exposure to derivative financial instruments through its investment in units of the pools. AIMCo uses derivative financial instruments to cost effectively gain access to equity markets in the pools, manage asset exposure within the pools, enhance pool returns and manage interest rate risk, foreign currency risk and credit risk in the pools.

By counterparty	Number of counterparties	Fund's Indirect Share	
		June 30, 2014	March 31, 2014
Contracts in favourable position (current credit exposure)	35	\$ 164	\$ 98
Contracts in unfavourable position	8	(18)	(72)
<b>Net fair value of derivative contracts</b>	<b>43</b>	<b>\$ 146</b>	<b>\$ 26</b>

- i) Current credit exposure: The current credit exposure is limited to the amount of loss that would occur if all counterparties to contracts in a favourable position totaling \$164 (March 31, 2014: \$98) were to default at once.
- ii) Cash settlements: Receivables or payables with counterparties are usually settled in cash every three months.
- iii) Contract notional amounts: The fair value of receivables (receive leg) and payables (pay leg) and the exchange of cash flows with counterparties in pooled funds are based on a rate or price applied to a notional amount specified in the derivative contract. The notional amount itself is not invested, received or exchanged with the counterparty and is not indicative of the credit risk associated with the contract. Notional amounts are not assets or liabilities and do not change the asset mix reported in Note 3. Accordingly, there is no accounting policy for their recognition in the Statement of Financial Position.



	Fund's Indirect Share	
	June 30, 2014	March 31, 2014
Types of derivatives used in pools		
Structured equity replication derivatives	\$ 101	\$ 91
Foreign currency derivatives	34	(66)
Interest rate derivatives	13	4
Credit risk derivatives	(2)	(3)
<b>Net fair value of derivative contracts</b>	<b>\$ 146</b>	<b>\$ 26</b>

- i) Structured equity replication derivatives: Equity index swaps are structured to receive income from counterparties based on the performance of a specified market-based equity index, security or basket of equity securities applied to a notional amount in exchange for floating rate interest paid to the counterparty. Floating rate notes are held in equity pools to provide floating rate interest to support the pay leg of the equity index swap. Rights, warrants, futures and options are also included as structured equity replication derivatives.
- ii) Foreign currency derivatives: Foreign currency derivatives include contractual agreements to exchange specified currencies at an agreed upon exchange rate and on an agreed settlement date in the future.
- iii) Interest rate derivatives: Interest rate derivatives exchange interest rate cash flows (fixed to floating or floating to fixed) based on a notional amount. Interest rate derivatives primarily include interest rate swaps and cross currency interest rate swaps, futures contracts and options.
- iv) Credit risk derivatives: Credit risk derivatives include credit default swaps allowing the pools to buy and sell protection on credit risk inherent in a bond. A premium is paid or received, based on a notional amount in exchange for a contingent payment should a defined credit event occur with respect to the underlying security.
- v) Deposits: At June 30, 2014 deposits in futures contracts margin accounts totalled \$69 (March 31, 2014: \$91) and deposits as collateral for derivative contracts totalled \$10 (March 31, 2014: \$17).

#### NOTE 5 NET FINANCIAL ASSETS (in millions)

Net financial assets represent the difference between the carrying value of financial assets held by the Fund and its liabilities. The following table shows accumulated net income and transfers to (from) the Fund since the Fund was created on May 19, 1976:

	Cumulative since 1976	
	June 30, 2014	March 31, 2014
<b>Accumulated net income</b>	<b>\$ 35,969</b>	<b>\$ 35,529</b>
<b>Transfers to the Fund</b>		
Resource Revenue (1976-1987)	12,049	12,049
Access to the Future <sup>(a)</sup>	1,000	1,000
Voted Payments	2,918	2,918
	<b>15,967</b>	<b>15,967</b>
<b>Transfers (from) the Fund</b>		
Section 8(2) transfers <sup>(b)</sup>		
Income	(36,174)	(35,734)
Amount Retained for Inflation-proofing	2,820	2,730
	<b>(33,354)</b>	<b>(33,004)</b>
Capital Expenditures (1976-1995) <sup>(c)</sup>	(3,486)	(3,486)
Transfers to Alberta Heritage Scholarship Fund <sup>(d)</sup>	(50)	-
	<b>(36,890)</b>	<b>(36,490)</b>
<b>Accumulated surplus from operations</b>	<b>15,046</b>	<b>15,006</b>
<b>Accumulated remeasurement gains</b>	<b>2,449</b>	<b>2,514</b>
<b>Carrying value of net financial assets</b>	<b>\$ 17,495</b>	<b>\$ 17,520</b>



- (a) Section 9.1 of the *Alberta Heritage Savings Trust Fund Act* (the Act) and Section 4(5) of the *Access to the Future Act* provides that up to \$3 billion may be transferred from the GRF to the Fund.
- (b) During the period, the Fund earned net income of \$440 million of which, \$90 million was retained in the Fund for inflation proofing and \$350 million is payable to the General Revenue Fund. Section 8(2) of the Act states that the net income of the Heritage Fund less any amount retained in the Fund to maintain its value, in accordance with section 11(1), shall be transferred to the GRF annually in a manner determined by the Ministry of Treasury Board and Finance. If the income of the Fund is less than that required to be retained, then the income, if any, shall be retained in the Fund. The estimated amount retained from income of the Fund is determined by multiplying the total equity of the Fund before the amount retained for inflation-proofing by the estimated percentage increase in the Canadian gross domestic product implicit price index (GDP Deflator Index) for the period. In accordance with section 11(3), if the GDP Deflator Index is a negative number, that negative number shall be treated as if it were zero.
- (c) Capital expenditures include transfers of \$300 million to the Alberta Heritage Foundation for Medical Research in 1980 and \$100 million to the Alberta Heritage Scholarship Fund in 1981.
- (d) Transfer to the Alberta Heritage Scholarship Fund is in accordance with section 7 of the *Savings Management Act* (SMA).

**NOTE 6 INVESTING IN ALBERTA'S INNOVATION AND FUTURE (in millions)**

The following accounts are established within the Heritage Fund to encourage innovation in Alberta and support strategic initiatives for the long-term benefit of Albertans and the Alberta economy:

**a) Social Innovation Endowment Account**

- i) The Account was established pursuant to the *Savings Management Act* (SMA) for the purpose of supporting innovation in the social service and support sector and in the cultural sector including research and education on social and cultural innovation, design and implementation of innovative interventions and development of new funding models and partnerships.
- ii) Effective on April 1, 2014, \$500 million, and on April 1, 2015, \$500 million is allocated to the Account from within the Heritage Fund.
- iii) Transfers from the Heritage Fund to the GRF in respect of Social Innovation are restricted in fiscal years 2014-15 through 2016-17 with a maximum transfer of \$nil in 2014-15, \$22.5 million in 2015-16 and \$45 million in 2016-17. Subsequently, maximum transfers are calculated as 4.5% of the average of the closing balances of the Account for the preceding 3 fiscal years.
- iv) The Account is adjusted for the rate of return reported by the Heritage Fund for the period.

**b) Agriculture and Food Innovation Endowment Account**

- i) The Account was established under the SMA for the purpose of supporting basic and applied agricultural research, including education on agriculture and food innovation and product development and commercialization in agriculture and related industries.
- ii) Effective on April 1, 2014 \$200 million is allocated to the Account from within the Heritage Fund.
- iii) Transfers from the Heritage Fund to the GRF in respect of Agriculture and Food Innovation are restricted in fiscal years 2014-15 through 2016-17 to a maximum of \$9 million each year. Subsequently, maximum transfers are calculated as 4.5% of the average of the closing balances of the Account for the preceding 3 fiscal years.

- iv) The Account is adjusted for the rate of return reported by the Heritage Fund for the period.

**c) Alberta Future Fund**

- i) The Account was established by the SMA for the purpose of supporting initiatives to provide long-term benefits to Albertans and the Alberta economy.
- ii) Effective on April 1, 2014, \$200 million, and on April 1 of the subsequent nine fiscal years, \$200 million is allocated to the Account from within the Heritage Fund.
- iii) Transfers from the Heritage Fund to the GRF in respect of the Alberta Future Fund are restricted to the balance in the Account and are determined by the President of Treasury Board and Minister of Finance for a purpose for which the Account was established and authorized by vote of the Legislature.
- iv) The Account is adjusted for the rate of return reported by the Heritage Fund for the period.

**d) Advanced Education Endowment Account**

- i) The Account was established pursuant to the *Access to the Future Act* for the purpose of funding the Access to the Future Fund in the Ministry of Innovation and Advanced Education. The Access to the Future Fund supports innovation and excellence that enhances and expands opportunities for Albertans to participate in accessible, affordable and high-quality advanced education opportunities.
- ii) A maximum of \$3 billion can be allocated to the Account from within the Heritage Fund of which \$750 million has been allocated in 2005-06 and \$250 million in 2006-07. The requirement to inflation proof the Account in the *Access to the Future Act* was repealed on April 1, 2014. Inflation proofing to March 31, 2014 totalled \$166 million.
- iii) The Account balance is reduced by amounts transferred from the Heritage Fund to the Access to the Future Fund calculated as 4.5% of the average of the closing balances of the Account for the preceding 3 fiscal years.
- iv) The Account is adjusted for the rate of return reported by the Heritage Fund for the period.

**NOTE 7** INVESTMENT INCOME (in millions)

The following is a summary of the Fund's investment income (loss) by asset class:

	Three Months Ended June 30,	
	2014	2013
<b>Interest-bearing securities</b>	\$ 59	\$ 38
<b>Equities</b>		
Canadian	41	(8)
Global	289	319
Private	77	12
	407	323
<b>Inflation sensitive</b>		
Real estate	24	34
Infrastructure	(9)	2
Timberland	(3)	24
Private debt and loan	-	(5)
	12	55
	\$ 478	\$ 416

The investment income includes realized gains and losses from disposal of pool units and income distributions from the pools.

Income distributions from the pools is based on income earned by the pools determined on an accrual basis which includes interest, dividends, security lending income, realized gains and losses on sale of securities held by the pools, realized foreign exchange gains and losses, writedowns of securities held in the pools and income and expense earned on derivative contracts. The cost of securities disposed of in the pools is determined on an average cost basis. Impairment charges related to the writedown of securities held in the pools are indicative of a loss in value that is other than temporary.

**NOTE 8** INVESTMENT EXPENSES (in millions)

	Three Months Ended June 30,	
	2014	2013
Amount charged by:		
AIMCo <sup>(a)</sup>	\$ 38	\$ 29
<b>Increase in expenses</b>	31.03%	11.54%
<b>Increase in average investments under management</b>	4.05%	5.02%
<b>Investment expense as a percent of:</b>		
Dollar earned	7.95%	6.97%
Dollar invested	0.21%	0.17%

<sup>(a)</sup> For investment management services. Please refer to AIMCo's financial statements for a detailed breakdown of expenses.

Includes \$29 thousand (June 30, 2013: \$33 thousand) charged to the Fund by Alberta Treasury Board and Finance for investment accounting and reporting services, and \$55 thousand (June 30, 2013: \$nil) paid to the International Forum of Sovereign Wealth Funds for membership.

**NOTE 9 INVESTMENT PERFORMANCE (net of investment expenses)**

Estimated investment returns are provided as supplementary information. The determination of the estimated return is based on fair values using quoted market prices and estimates of fair value where no quoted market prices are available. The estimated return includes gains and losses that have not been realized. Estimated benchmark returns are based on published market-based indices and estimates where no published index is available.

	Three Months Ended June 30,		Average Annualized Return	
	2014	2013	5 years	10 years
<b>Time-weighted rates of return, at fair value <sup>(a)</sup></b>				
<b>Estimated return <sup>(b)</sup></b>	2.1%	1.0%	11.6%	7.7%
<i>Estimated policy benchmark return <sup>(b)</sup></i>	2.5%	0.9%	10.4%	7.3%
<b>Value added by investment manager <sup>(c)</sup></b>	-0.4%	0.1%	1.2%	0.4%

(a) The time-weighted rate of return involves the calculation of the return realized by the Fund over a specified period and is a measure of the total proceeds received from an investment dollar initially invested. Total proceeds include cash distributions (interest and dividend payments) and capital gains and losses (realized and unrealized).

(b) Investment returns are provided by AIMCo. The overall return and benchmark is based on investment returns and benchmarks for each asset class. Investment returns for assets classified as real estate, private equities, infrastructure, hedge funds and private debt are based on estimates of fair value. For these investments, measurement uncertainty exists because trading activity is infrequent and fair values are derived using valuation techniques which incorporate assumptions that are based on non-observable market data. Reasonably possible alternative assumptions could yield an increase or decrease in the fair value amounts and investment returns reported for these types of investments. Any change in estimated returns, resulting from new information received after the cut-off date for preparation of the Fund's financial statements, will be reflected in the next reporting period.

(c) In the SIP&G, the Ministry of Treasury Board and Finance expects that the investments held by the Fund will return approximately 100 basis points, or 1% per annum, above the policy benchmark.

**NOTE 10 FINANCIAL STATEMENTS**

These statements were prepared by the Department of Treasury Board and Finance in accordance with section 15(1) of the Act.

Alberta

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